# Daily comment

Monday 16 June 2014

## Xchanging, Airbus, Safran, President Energy, Slater & Gordon, Mulberry

### Xchanging XCH:LN 152.5p Mkt xap £372m Analyst: Sohil Chotai

**Exchanging sales for margins**

We met Xchanging last week and drew some insights into the continued turnaround as the business evolves into a higher value-add technology solutions provider with a simpler business model.

We gained comfort that the Lloyds' central services modernisation program (Project Darwin) would not hurt the platform, scale and relationships that Xchanging has built, and this highly cash-generative segment remains the cornerstone of the business.

Some risk (upside and downside) exists with the workers' compensation contracts in New South Wales, which are currently up for renewal. Xchanging currently only has a 5% market share of this contract and as such it is barely profitable. However, with the re-bids being for a minimum of 15% market share, and Xchanging updating its technology capability using Xuber, if they win a larger contract this could be a meaningful addition to group EBIT. Losing the contract would have a small impact on revenues but lead to a write-down of the investment in software (of mid-single digit £m) but we do not view this as a serious concern overall. The insurance services segment earned an adjusted operating margin of 21.8% for 2013, which we expect the company to maintain in the near term.

The financial services business has undergone significant change with acquisitions (AR Enterprises) and disposals (Xchanging Transaction Bank) and now comprises Xchanging Italy and Fondsdepot Bank. The disposal of XTB streamlines the business and should help deliver clarity to investors as EPS will become a cleaner, more meaningful metric. Xchanging Italy has swung into profitability and in the longer term could be a business that earns double-digit operating margins. Fondsdepot Bank remains in an undeveloped market with growth and consolidation expected to take place, as well as further digitalisation.

Technology is likely to be the main source of growth in the application management services and insurance software. Xuber is a comprehensive product suite covering end-to-end solutions for all participants in the insurance market. It was re-launched in 2012 and could be a significant contributor to sales and margins for the business going forwards. While currently not significantly profitable, it is expected to double or treble in size over the next few years and has the potential to achieve 20% operating margins. **Xuber's closest competitor, Guidewire Software (GWRE:US), trades on FY14 EV/EBIT of 40.6x and an FY14 P/E of 70.2x, and a key part of Xchanging's re-rating story could be Xuber**. It is important to note that Xuber beat Guidewire Software and Accenture's Duck Creek Technologies in a contract for a suite of four modules for Everest Re, a large US-based reinsurer. The technology segment earned a 9% adjusted operating margin in 2013 and we would expect to see this improve significantly over the long term.

MarketMaker4 (MM4) was a very important acquisition for Xchanging's procurement division as it allows it to provide technology-based solutions to a large customer base and gain clients very quickly. Adjusted operating margins were extremely low in 2013 (3.3%) as the business is in a transitional phase and we expect MM4 to allow more cross-selling opportunities and improve the group's procurement platform.

The business has also transformed with a move to a new headquarters, a more sales-driven culture and a focus on winning a higher volume of flexible contracts. **With interim results announced on 31 July, we will be looking for flat operating profit guidance to be met as well as further customer wins for Xuber and MM4.**

**On our estimates, Xchanging trades on an undemanding multiple of 2014e adjusted EV/EBIT of 5.6x and on a 2014e adjusted P/E of 14.6x. We believe the market understands this is a transition period for the company and it is likely to produce flat EPS for 2014 with a return to growth guided by management post 2014, which should see the shares close the discount to the rest of the peer group.**

## Airbus AIR:FP €51.23 Mkt cap €40bn Analyst: Sash Tusa
## Safran SAF:FP €49 Mkt cap €20bn

Airbus and Safran have announced this morning that they have agreed to merge their satellite launcher activities into a 50:50 joint venture. Neither company discloses any financial detail, but we estimate that each company's total launcher/ballistic missiles activities are in the order of €1bn of annual revenues, so the pure civil activities will be a minority of each of these. As such, any deal is non-material to either company, but of significant importance to the European space industry and, especially, to relations between France, Italy and Germany.

Airbus, through its Astrium business, is an integrator of satellite launchers (the Ariane family, currently the most successful and reliable western-built launcher). It performs the same role for the M51 submarine-launched ballistic missile for France; we emphasise that the military and civil launcher businesses are exceptionally closely linked, using a very high proportion of common technologies, components and skills.

Safran, by contrast, is a subcontractor to Astrium, producing the rocket motors. These are predominantly liquid-fuelled for civil launchers, and solid rockets for military use but, under pressure from Elon Musk's SpaceX, the next-generation Ariane 6 is likely to be solid rocket-powered.

We see this proposed deal as a direct reaction to the threat posed by SpaceX, which may be able to offer civil satellite launch for as little as 60% of the price of Ariane 5. Airbus CEO Tom Enders has been very blunt that the entire European launcher business needs to be shaken up, and the principle of juste retour abandoned, if Ariane is to remain competitive.

In our view, this proposed Franco-French deal will put pressure on Germany (which manufactures the Ariane 5 fuel tanks and structure, little of which would be needed for a solid rocket-propelled successor). It also puts pressure on Italy, which has been making a push for Avio to lead Ariane 6, given its technical leadership of the small (solid rocket-propelled) Vega launcher. Avio is currently for sale by its owner Cinven; Finmeccanica has a small minority stake. Both Airbus and Safran have individually expressed an interest in buying Avio, but this appears to have been vetoed by the Italian government(s), hence the decision by Airbus and Safran to merge their activities instead.

How will this all pan out?

- Ultimately, we see a civil launcher merger as the catalyst for Airbus and Safran to join their entire launcher/propulsion activities (ie including military as well) into a c €2bn combine. We have no view at this stage as to which company would end up leading the business.
- We think it possible that Cinven will be encouraged to sell its Avio stake either back to Finmeccanica or to an Italian government holding company to maintain a national champion.
- European governments are going to need to find up to €2bn to fund Ariane 6 development over the next 5-10 years, a lot within the constraints of the European Space Agency's (ESA) annual budget of €4bn pa.

- The risk, therefore, is that without even greater corporate developments (mergers, integrations and divestments), the European launcher business (which contributes to the politically-sensitive "guaranteed [European] access to space") could deteriorate commercially, and ultimately, technologically.

### President Energy PPC:LN 36p Mkt cap £142m Analyst: Will Forbes

The major news this morning is that President has identified a third and potentially very large play type for its Paraguay exploration programme that has coincidentally started over the weekend with the spudding of the Jacaranda x-1 well. Looking at the deeper targets than the previous mapped Cretaceous Yacoraite and Carboniferous/Upper Devonian Los Monos plays, President has identified a third play type in the deeper Lower Devonian/Silurian Santa Rosa. This is a basin-wide gas/ condensate play across the Chaco region, so if proven successful there would be significant upside to President's position in Paraguay. President is immediately escalating drilling of the largest target in the new play type, the 5.2tcf gas/157mmbbl condensate Lapacho prospect. This will now be drilled as part of the current three well drilling programme, with the previously planned Yacare prospect falling off the list.

**At more than 1bnboe Lapacho is significantly larger than any of the other prospects identified to date by President, including the 624mmboe Jacaranda prospect that is currently being drilled. We can expect results of the Jacaranda x-1 well towards the end of August with the Tapir x-1 well and Lapacho now confirmed as the two follow-up wells in the current drill programme.**

### Slater & Gordon SGH:AU A$4.93 Mkt cap A$1.01bn Analyst: Mark Thomas

**Slater & Gordon (SGH) is the leading consumer law firm in Australia and has been expanding into the much larger UK market, which we review in detail in this note. Its differentiating features include economies of scale, work process engineering and using its brand to market directly to clients. Its UK operations appear less exposed than the market to the Jackson reforms and the Mitchell ruling, and they should provide opportunities for both organic and inorganic growth.**

SGH achieves material economies of scale by mapping legal processes and identifying opportunities for aspects of the work to be automated and/or performed by supervised staff, who while not admitted to practise as lawyers themselves are supervised by qualified lawyers and trained to perform key components of work. For example, it is much more efficient to chase doctors for medical reports through an administration centre than having expensive lawyers do so. Developing back-office expertise improves service levels and leads to more rapid case conclusion, which means better cash flow. SGH's scale also gives it access to capital markets, which is important for funding working capital, which can be a major constraint on business growth. SGH is also differentiated by using its brand to market direct to customers rather than relying on third-party introducers. This may prove especially advantageous in the UK, where changes in regulations may see such third-party distribution under the greatest pressure.

SGH estimates it has a market share in Australian personal injury cases of c 20%. It expects this market to grow by 5% pa. Its market share of other personal legal services is around a fifth of this. SGH intends to use its brand to increase this share, with top-line growth in non PI consumer legal services expected to grow at >10% pa on average. In the UK – a market considerably larger than Australia – SGH's market share is now c 5%. FY14 will see the benefit of acquisitions with future organic UK revenue expected to grow c 8-10% pa. SGH is less exposed than most to regulatory reforms and pressure on weaker players is expected to see consolidation. SGH also has a successful track record of acquisitions in Australia and the UK, and it is anticipated that acquisitions will add a further layer of growth.

The shares are trading modestly below the average of valuation approaches. The quoted peer, Shine, trades at a 2014 P/E of 15.9x.

### Mulberry MUL:LN 700p Mkt cap £420m Analyst: Victoria Buxton

Mulberry is proud to be an English brand, in the unique position of being able to boast >50% of its product is manufactured in England. Having focused its creative attentions a little too far up the price architecture in the last couple of years (>£1,000 handbags), it has listened to its core customer base and refreshed its core product portfolio in the £500-800 price bracket, with exciting new styles and colours to be introduced progressively through the A/W14 and S/S15 seasons.

Despite the obvious gaps in senior management roles that the board is currently looking to fill (CEO and creative director), the depth of talent throughout the organisation should not be underestimated and cannot be easily recreated by its competitors. In 2006 the company started an apprentice scheme to train and develop English talent in highly specialist manufacturing skill sets. Of the original 10 apprentices, eight are still with the company, some now in management roles, reflecting the long-term commitment of the firm to its employees and vice versa.

Mulberry's headline FY15 P/E of 48.3x appears expensive, but given its operational gearing, an acceleration in top-line growth would result in a very significant rebound in earnings, which in our view is not currently captured in consensus earnings

Best regards,
Jeremy Silewicz

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